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Pause or Plunge?

"At a late stage of speculation, a larger and larger group of people seeks to become rich without a real understanding of the processes involved. Not surprisingly, swindlers and catchpenny schemes flourish."

Manias, Panics and Crashes
Charles Kindleberger, 1978

The economic skies are darkening over Wall Street, even as the bulls enjoy the fruits of their late-summer run to record highs on the major stock indexes. We think a long winter of disappointments could lie ahead.

The consensus crowd, on the other hand, continues to bask in sunny optimism. Evidence of slowing U.S. economic growth is heartily welcomed as an antidote to the threat of a Federal Reserve interest-rate hike – widely seen as the sole potential threat on the horizon. Weak growth abroad only compounds the euphoria, since it would seem to promise an indefinite reign of global loose money.

What about the U.S. economy's sudden slowdown? Final sales growth has slumped from 4.1% to 0.3% at an annual rate. Is this a pause, or a new trend? The growth optimists want to believe that the accumulated huge wealth effects from the boom in the markets and high consumer confidence will refuel the consumer borrowing binge.

They overlook the fact that more than anything else, it was massive mortgage refinancings that have stoked this borrowing binge. That, however, has completely dried up. Another question is whether its continuation is at all desirable from a long-term perspective.

We think that with exports and investments weakening, the economic slowdown now unfolding in the United States soon will cross the line from desired to undesired sluggishness. Wall Street, celebrating any sign of weakness, has yet to learn the crucial difference between the two.

In recent letters, we have analyzed the sorry reality that the corporate profit boom of the 1990s had its true cause in various one-time factors, mainly the collapse in interest costs, rather than in lasting efficiency gains. This letter brings further bad news about profits.

In scrutinizing the flows of funds into the markets, we made a discovery that puts the mutual-fund "mania" of the 1990s into a new, much less bullish light. The soaring flows this year largely, if not mostly, reflect a drastic shift in retirement contributions and investments from pension funds to mutual funds.

Unprecedented volatility both in U.S. bonds and stocks is keeping investors in suspense. Gross overvaluations and rampant, leveraged speculation essentially have made bourses ever more vulnerable. New, sophisticated strategies that try to hedge against any risk, in reality intensify volatility.

The great worry of 1997 will be of a U.S. economy that proves much weaker than expected. That bodes ill for the dollar and U.S. stocks. Rising prospects for rate cuts by the Fed initially will cheer the markets. But in the long run, it's very bad news – both for the United States and the world economy.

Given the enormous growth in derivatives trading and the tremendous volatility it has engendered, the turn in the markets is likely to be abrupt and the decline self-reinforcing.

LOOSE MONEY AS FAR AS THE EYE CAN SEE

When U.S. stocks took off in late July in defiance of the then-prevailing interest-rate jitters, the bull story was that sustained, strong economic growth boded well for business profits. Then, during the course of September, virtually the opposite story became the rage in the markets – namely, signs of slower economic growth were held to imply unchanged if not falling U.S. interest rates. The effect was like uncorking a bottle of champagne.

Indeed, some commentators turned almost ecstatic. To quote one of them: "Quite possibly, it is just too good to be true. Nonetheless, financial market developments suggest the emergence of a trend so rosy that even the most partisan writer of economic scenarios might have hesitated to predict it. Slower than expected growth in the United States, eliminating the fear that the Fed will raise interest rates, is giving new life to the U.S. bond and equity markets, pulling in foreign investment that keeps interest rates low. The resulting extension of the U.S. economic expansion, in turn, is driving up the value of the dollar, which diverts consumer demand to the still sluggish markets in Western Europe and Japan and fuels solid recoveries there."

Since slower growth in the United States and inaction by the Fed were exactly in line with our expectations and forecasts, this turn in outlook was a non-event for us. But admittedly, for that very reason we also failed to realize how much the Fed's idleness would animate the bullish spirits in the financial markets. Our thoughts were of the adverse effects of slower economic growth on business profits.

The first trigger for the new speculative spree may have been the economic events of August. First, the Tankan survey of business confidence in Japan revealed a stumbling economic recovery, excluding any possibility of an impending rate hike in Japan. Then, in Europe, the Bundesbank at last decided to cut its repo rate by a more-than-expected 30 basis points, from 3.3% to 3%. This was quickly followed by a cut in the Swiss discount rate from 1.5% to 1%. On top of all this global monetary looseness came the respite in dollar interest rates. Altogether, it was taken in the financial markets as assurance that loose and cheap money will be available at least for the rest of this year.

Apparently, that's still the prevailing opinion in the markets. In this view, the Fed's first rate hike merely has been postponed until after the presidential elections. Behind this assumption is the widespread belief that the U.S. economy will continue to grow at above its potential growth rate until monetary policy is tightened. There is a general belief that the economy has too much vigor to slow of its own accord.

That's where we disagree. A leading idea in our economic thinking is the key postulate of Austrian theory: Recessions and depressions ensue primarily from the malinvestments and maladjustments engendered by the credit and debt excesses of the preceding booms. The only way to prevent the inevitable recession is to stop the excesses with timely monetary tightening. The longer this is delayed, the worse the eventual consequences.

As we have repeatedly stressed in past letters, the main reasons for our expectation of a prolonged downturn in the U.S. economy are the unsustainable consumer-borrowing binge and the grossly overinflated stock market. Together, these excesses make the U.S. economy highly vulnerable to a serious setback.

In our last letter, we remarked that U.S. consumer income growth of $1.2 billion since the end of 1992 has been matched by an equal amount of debt growth. This was met with considerable disbelief by some of our subscribers. Well, here are the precise figures: Since 1992, U.S. consumer incomes have risen by $1,195.9 billion, while total consumer debt, including home-mortgage debt, has risen $1,212.6 billion. For every new dollar earned, *more* than one dollar has been added in debt.

Together, the flows from these two sources added up to a staggering increase in available consumer purchasing power of $2,408.5 billion. But current consumer spending rose merely $920 billion. The essential implication is that the huge difference must have been spent on the purchase of assets. Interest payments, by the way, are included in consumer spending. Home mortgages accounted for about $680 billion of the increase in debts. Much of this total,

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (October 28)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	2.2%	6.0%	12.9%	-1.8%	13.5%
Canada	4.8%.	17.8%	28.1%	-0.4%	28.1%
France	2.1%	14.9%	23.4%	-1.6%	23.4%
Germany	1.7%	20.0%	29.0%	-1.1%	29.0%
Hong Kong	4.3%	21.7%	26.7%	-2.0%	32.0%
Japan	-2.7%	5.5%	20.9%	-7.5%	20.9%
Mexico	-0.6%	15.8%	43.2%	-6.3%	43.9%
Spain	4.5%	20.7%	36.4%	-0.5%	36.4%
U.K.	2.0%	9.1%	15.1%	-1.2%	15.1%
U.S.	1.6%	13.2%	20.3%	-1.9%	20.3%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (October 28)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	7.41	-36	-86	-123	-175	5
Canada	6.66	-49	-42	-119	-131	26
France	5.98	-12	-65	-134	-134	8
Germany	6.37	-6	-1	-44	-66	22
Japan	2.68	-26	-40	-31	-86	0
Spain	7.77	-10	-193	-316	-316	20
U.K.	7.56	-11	13	-53	-68	32
U.S.	6.56	-22	99	51	-51	103

Exchange Rates

Versus U.S. Dollar, % Change

Country (October 28)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.26	0.1%	6.2%	4.8%	-1.3%	7.4%
Canada ($)	1.35	1.3%	1.4%	1.3%	2.9%	-0.7%
France (*f*)	5.13	0.4%	-4.5%	-4.9%	-5.8%	1.9%
Germany (DM)	1.52	0.3%	-5.7%	-7.9%	-8.0%	1.8%
Japan (¥)	114.3	-3.1%	-10.4%	-12.2%	-13.6%	0.0%
Spain (Pt)	127.96	0.1%	-5.2%	-4.6%	-6.0%	1.6%
U.K. (£)	1.61	3.2%	3.9%	2.3%	-0.4%	8.0%

though, was mortgage refinancing debt, which served to raise cash for spending on purposes other than home buying. We continue to wonder: Where did all this borrowed money go?

A WEAK AND VULNERABLE RECOVERY

In trying to assess the U.S. economy's underlying strength, most observers tend to focus on the United States' outstanding job-creation performance. Indeed, it deserves our unmitigated administration. An exceptionally dynamic and flexible labor market certainly is the U.S. economy's main pillar of strength. Yet, it shouldn't blind us to the big negatives inherent in that same development.

The salient point to see is that for the United States, too, the current cyclical recovery is by far the weakest of the entire postwar period. Like the economies of Europe and Japan, the American economy is performing significantly worse than in past cycles. Measured from the recessionary trough of early 1991, real U.S. GDP growth has totaled just 14%, or 2.7% annually.

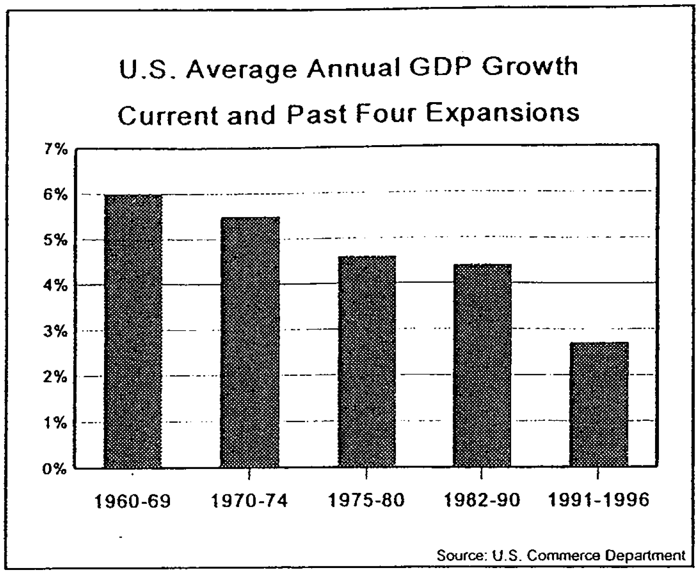
By comparison, over the years 1948-73, the average U.S. real GDP growth rate was 3.9%. This was achieved by 1.6% average annual growth in employment and 2.3% average annual growth in productivity. Strong labor force growth and employment growth has been a permanent feature of the U.S. economy right through the postwar period. But until the early 1970s, the economy also was able to deliver strong productivity growth – enough to accommodate impressive gains in real wages.

This is the decisive, striking difference between today and the past. Only strong job creation has survived, while productivity growth abruptly collapsed in the early 1970s and has never recovered. Of the annual 2.7% real GDP growth in the current recovery, 1.2% was accounted for by productivity gains and 1.5% by gains in employment (work hours). The end of high productivity growth essentially was the end of high real wage rises.

What's more, wage increases now even tend to lag behind inflation, implying a slowly declining living standard for the average American. In their role as workers, then, Americans have perfectly adjusted to the productivity collapse. Cheap labor, in turn, has allowed for the continuation of high employment growth.

In their complementary role as spenders, however, most Americans refuse to adjust. Faced with falling real wages per capita, but determined to maintain their standard of living, U.S. consumers have stampeded into debt. In the last analysis, it is this two-fold borrowing binge that has shielded per capita consumption from a sharp decline. Internally, it is the heavy borrowing done by the individual consumer, and externally it is the chronic, huge

excess of imports over exports – financed by a rapid rise in foreign indebtedness – that has allowed Americans to live beyond their means for so many years.



REALITY VERSUS PERCEPTION

Returning to the all-important, near-term questions: Will the U.S. economy surprise on the strong or weak side in the coming months? Will the Fed's next move be a rake hike or a rate cut? Given that we regard the U.S. economy as far more vulnerable than the consensus realizes, we believe the latter is more likely.

But vulnerability doesn't rule out momentary strength. This was seen in the second quarter, as U.S. GDP grew at a 4.7% annualized rate. Actually, there was less to this growth spurt than met the eye. Its main cause was a brief, anomalous surge in federal spending – the inevitable aftermath of the partial government shutdown engendered by last year's budget dispute between President Clinton and the Republican Congress.

One of the more annoying excesses in the U.S. economy is the overabundant supply of trivial statistics that do more to obfustcate than clarify the outlook. Just as the numbers zig and zag, so do the markets. Our approach, on the other hand, focuses on the fundamentals, and on a few statistics that have strategic importance. At present, these are the indicators of consumer finances and business profits. In both, we see big differences between general perception and reality. These are sure to spell big trouble down the road.

The tables on the opposite page pinpoints the trouble spots. The second one exhibits the contributions of the major demand components to U.S. GDP growth. As we mentioned, the jump in GDP in during the second quarter clearly reflected a big distortion in government spending, and a burst in consumer expenditures. Not surprisingly, this burst followed on the heels of exceptionally strong disposable-income growth in 1995's second half.

It should be noted, however, that disposable- income growth abruptly faltered in the first half of this year. It slumped to less than 2%, from more than 4% in the second half of 1995. The third quarter of 1996 is sure to be still worse.

Putting the pieces together, we can see that the consumer's spending power clearly is being squeezed both by shrinking income and slowing debt growth. The income side of the pinchers essentially stems from slower employment growth. The borrowing side can be explained by a recent study from the St. Louis Federal Reserve that points to a significant tightening in bank-lending standards.

Indeed, the consumer actually has retrenched. After a final spurt in February of this year, real retail sales have fallen slightly, while overall consumption growth has turned decidedly sluggish. This last component of GDP is sure to show only a minimal increase in the third quarter, compared to a 3.5% growth clip in the first half of this year. Is this near-stagnation a pause or a turning point leading to a progressive slowdown? That's the cardinal question about the U.S. economy at the moment.

The growth optimists view this as a mere pause. Strong consumer fundamentals, the growth bulls say, point to a resumption of the spending spree. But in light of the pronounced slowdown in consumer income and debt growth mentioned earlier, we can only wonder what fundamentals the bulls are looking at. Debt-service payments have climbed back toward their late-1980s peak of 17% of disposable income.

It would seem that the great positive fundamentals the growth optimists have in mind are the enormous wealth effects created by the booming financial markets, and the near-record levels of consumer confidence. Together, these are supposed to warrant a vibrant season of Christmas shopping in the fourth quarter. For many economists today, the current quarter is the sum total of their long-term thinking.

Percentage Changes in U.S. Economic Indicators

	1995	95 Q1	95 Q2	95 Q3	95 Q4	96 Q1	96 Q2
Real GDP, annual rate	2.0%	0.4%	0.7%	3.8%	0.3%	2.0%	4.7%
Real Domestic Purchases	2.0%	1.4%	0.7%	2.6%	-0.7%	3.0%	5.4%
Real Disposable Income	3.5%	3.7%	0.3%	4.3%	4.4%	2.0%	1.6%

Percentage Contributions to U.S. Real GDP Growth
Annual Rates

	1995	95 Q1	95 Q2	95 Q3	95 Q4	96 Q1	96 Q2
Personal Consumption	1.6%	0.6%	2.1%	1.6%	0.7%	2.4%	2.3%
Private Investment	0.5%	1.0%	-1.6%	1.1%	-0.6%	0.4%	1.6%
Net Exports	0%	-1.0%	0.1%	1.2%	0.9%	-1.1%	-0.6%
Public Spending	0%	-0.2%	0.1%	-0.1%	-0.8%	0.3%	1.5%

Source: U.S. Department of Commerce

While we readily must admit that nothing is impossible, we regard such a revival in consumer spending as highly unlikely. The scenario painted by the growth bulls really amounts to a form of voodoo economics, in which a booming stock market becomes the *deus ex machina* that drives the economy. The first questionable assumption, of course, is that the bull market will continue in full force. The bulls waste no thought on the possibility that a major stock-market decline might have a powerful contractive effect on the economy.

WEALTH EFFECTS VERSUS THE MORTGAGE REFINANCING BONANZA

To be sure, the American consumer has benefitted immensely from the financial boom. But the main channel through which consumer spending has been heavily bolstered during the 1990s is by no means the wealth effects of the soaring stock market. Rather, the driving force has been the substantial income effects accruing from the boom in home-mortgage refinancing, which in turn has stemmed from the rising bond market and the steep decline in interest rates. By slashing debt-service burdens, this has fostered the raising of new debt.

What really happens in any such refinancing boom is a wholesale transfer of income away from the savers who hold debt to the debtors who owe it. Since savers generally have a low marginal propensity to spend, while debtors have a high propensity, the net effect is a reduction in the savings rate and a rise in consumer spending. This windfall played a large role in powering economic growth from 1991 to late 1993, but stopped dead in its tracks in 1994, when bond prices collapsed. It surged again in 1995 when the bond market recovered. But since this year, as bond prices have fallen again and bond rates have risen, refinancing activity again has dried up.

The sequence is quite clear to anyone who has studied the data: Refinancing activity peaked in February; real retail sales stopped rising in March. In this light, hopes for a Christmas spending binge appear grossly misplaced. True, a booming stock market certainly helps boost consumer psychology. Yet the hard money needed to power any rise in spending would have to come from a renewed mortgage refinancing bonanza.

If, as we expect, consumer spending disappoints, what growth contributions can be expected from the other sectors of the economy – that is, from government spending, business and residential investment and net exports?

To begin with government spending, it is sure to contribute nothing after its second-quarter splurge. As to business capital spending, it is bound to make a positive contribution, but at a declining rate of growth. New orders

for non-defense, non-aircraft capital goods are sharply down. Home building is holding up, but its potential contribution – about 0.3% to 0.5% of GDP – is too small to make a significant difference in total economic growth.

OMINOUS TRADE TREND

Of unquestionable, critical importance not only for the dollar but also for the U.S. economy is foreign trade. Its drastic deterioration has been the big, unpleasant surprise so far in 1996. The double-digit export growth of 1994-95 has fallen off abruptly, while imports reaccelerated after a brief lull in 1995. Inevitably, the soaring current-account deficit has turned into a significant drag on GDP growth. According to the most recent figures, that negative trade trend worsened in the third quarter, again draining GDP growth, which this time will prove very weak.

Just as an aside: Since 1992, the U.S. current-account deficit has more than doubled, from $62.5 billion to nearly $150 billion. Of its various components, one, the merchandise trade deficit, hit $173 billion last year, an all-time high. But a rapidly improving balance in services trade has kept the overall balance on goods and services to around $105 billion last year, well below its previous peak of $150 billion in 1987.

A new, growing negative, however, is the balance on investment income. In 1994, income payments on foreign U.S. assets for the first time overtook U.S. receipts on assets abroad. While the net income deficit was a mere $8 billion in 1995, that compares to a former U.S. net surplus of around $30 billion in the early 1980s.

The sharply deteriorating trade balance has cut U.S. economic growth in 1996 significantly. Yet it generally is ignored or taken very lightly. The general, comforting assumption is that this shortfall chiefly reflects the existing, considerable cyclical divergences between the United States and some of its important trade partners, mainly Europe, Japan, Canada and Mexico. As these economies are in the process of recovering, so the assumption goes, U.S. exports to these areas will rebound to the benefit of both the dollar and the U.S. economy.

There surely is some truth to this assumption. Yet we must offer a caveat. In most of the industrialized countries, the pace of expansion is too weak to diminish existing output gaps. The U.S. economy, by contrast, is at or close to full capacity. Furthermore, high productivity growth in Europe and Japan is holding up existing output gaps. Actually, the non-U.S. recoveries, particularly in Germany and Japan, are export-led. Domestic demand growth continues to lag. And while the Tiger economies of Asia continue to enjoy high growth, they are not accelerating.

THE ELUSIVE BUSINESS CYCLE

It has become a questionable habit to call any measurable increase in GDP, however tiny, a "recovery." By this gauge, the economies in Europe and Japan indeed are enjoying an economic recovery. But what is happening has virtually nothing in common with the cyclical patterns of the past.

Past recessions always were caused by monetary tightening, provoked by economic overheating. Sooner or later, tight money slowed economic growth and depressed the financial markets, both bonds and stocks. In turn, when central banks loosened their reins, markets as well as economies took off again. The twin outstanding features of this pattern of strong business cycles and strong economic growth were high rates of saving and investment.

Of equal importance, recoveries, once started, typically became self-sustaining and even self-accelerating, mainly because of strong investment cycles. Three or four years into a recovery, economies regularly overheated, generally compelling the central banks to drastically tighten monetary policy. In this way, economies and markets moved in a regular cyclical pattern. Overall, there was more of a need to restrain rather than stimulate the economies.

Today, exactly the opposite is the case. The great positive factor of the present is that the industrial countries are enjoying their lowest inflation rates in thirty years. Unfortunately, this great achievement has an utterly negative reason: the demise of the business cycle and of long-term economic growth, generally associated with stagnating

living standards. As the responsiveness of economies to monetary easing has been sharply diminished, loose money has become a seemingly permanent necessity to maintain any economic growth at all.

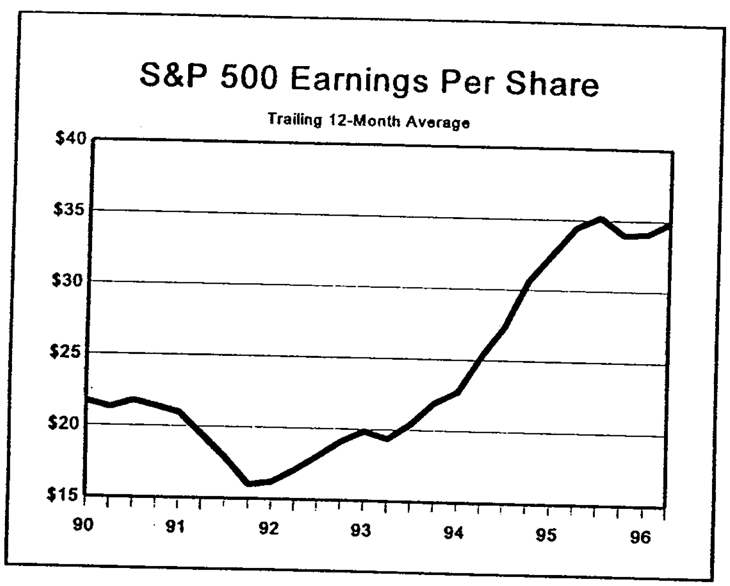
As we have often stressed, the roots of the breakdown of economic growth and the normal business cycle can be found in the deep-seated structural maladjustment that are the legacy of the various past excesses. Their chief common causal denominator is massive capital consumption through public and private overconsumption.

WHERE ARE THE RISKS?

The IMF's latest global economic assessment envisions a modest acceleration of economic growth world-wide, coupled with continued good behavior of consumer- and producer-price inflation. Altogether, it paints a rosy scenario that nicely confirms the prevailing rosy perceptions in the financial markets. In terms of hard numbers, the IMF predicts unbroken U.S. economic growth and significant recoveries in Europe, Japan and Canada. Like the market consensus, it sees no risks to the slow-growth, low-inflation scenario. Or at least, it doesn't mention any.

The one part of the forecast that we wholeheartedly endorse is the projection of continuous low inflation. But regarding the predicted recoveries in Europe and Japan, we are not so upbeat. There is more fragility apparent than cyclical dynamism. Any surprises, we would say, would be to the down side.

But our major dissent concerns the U.S. economy. We fully expect it to surprise with pronounced weakness. This holds considerable risks for the dollar and the U.S. stock market.



For the reasons explained, we can't subscribe to the prevailing view that consumer finances are strong enough to permit a new borrowing and spending binge. What's more, we have serious misgivings about business investment and profits, which have been important driving forces in this expansion.

In recent letters, we have explained that the much-admired profits boom of Corporate America in the 1990s in reality was a mirage. It accrued not from sustainable efficiency gains but from the steep fall in interest costs and other nonrecurring influences. The stock market, hyped by Wall Street propaganda, mistakenly discounted this transitory profits boom as a new trend, one that will extend far into the future. But the essential, inherent implication of our analysis is that Wall Street faces an imminent, drastic profits decline. As a matter of fact, profits abruptly turned flat early in 1995. But for more than a year, Wall Street has been in total denial of the sharply deteriorating profits picture.

Actually, there are three relevant sets of profits figures. Wall Street's attention is focused on reported earnings per share, which companies declare quarterly. The aggregate numbers are computed and published weekly with respect to the companies covered by the various U.S. stock indexes. A second set, compiled and published quarterly by the *Wall Street Journal*, includes total reported profits of some 600 to 700 corporations. Finally, a third set of earnings, computed and published quarterly by the U.S. Commerce Department, is derived from its national income and product accounts. These commonly are referred to as NIPA profits.

The first set – profits per share – as well as the second set – total profits – are both based on the earnings that corporations report quarterly. But expressed in terms of percentage growth, they can differ quite considerably owing to the huge corporate stock purchases of recent years stemming from buy-back programs, mergers and acquisitions.

As the equity base has shrunk, profits per share have increased. NIPA profits – the third set – also differ from reported earnings in important ways. Capital gains and one-time write-offs, for example, are excluded.

THE PROFITLESS STOCK MARKET BOOM

What exactly has happened to profits and their market valuation over the past 12 months? In short, they have diverged as never before. We have compared the year-over-year changes in reported earnings per share with the corresponding price/earnings ratios, based on the various stock indexes. Here are the results:

- For shares in the Dow Jones Industrial Average, earnings per share rose 2.4%, while the average PE ratio rocketed by 24%.

- Shares in the S&P 500 registered a 1.4% rise in earnings, as against a rise in the average PE ratio of 19%.

- In the case of the S&P 100 – the S&P Industrial Index – a decrease (that's right, a decrease) in earnings per share of 5.5% compared with a surge in the average PE ratio of a staggering 29%.

The most recent actual PE ratios for the three indexes were 18.6, 20.36 and 23.3, respectively. To put these figures in some perspective, the long-term average PE ratio for the U.S. market is 14.

Obviously, Wall Street has succeeded in radically decoupling the stock market from weakening corporate earnings. Market valuations have soared in total isolation from stagnating or falling profits. We have been looking at this remarkable trend with two questions in mind: First, how could this drastic deterioration in the profits picture go completely unnoticed for so long? Secondly, when will the markets finally awaken to the profits imbroglio?

From what we hear and read, it is clear the investing public doesn't have the faintest idea what has been happening to business profits. With or without malign intent, the profits disclosures of U.S. corporations have been couched in a way that systematically misinforms. In the prevailing euphoria, good news is uncritically swallowed.

As we have described in past letters, the primary ruse was and still is to measure profits against whittled-down late estimates that largely are determined by the corporations themselves. In this way, profit declines magically are transformed into "better-than-expected" earnings. Another widely practiced shell game is to boost profits per share – on which investors predominately focus - through large corporate stock buy backs.

Recently, for example, IBM enraptured the market with news that profits per share of $2.45 in the third quarter were up against year-ago profits of $2.30, and expected third-quarter profits of $2.44 per share. But total profits of $1.28 billion actually were *down* from $1.3 billion the year before. The entire boost in profits per share was the work of stock buy backs, not of truly higher earnings.

THE WORSENING SUPPLY-DEMAND BALANCE

In our view, the sharp deterioration in the profits trend is the main threat to the U.S. stock market. At the same time, it also is highly negative for the economy. As go profits, so go investments and the economy. Thus, it strikes us as no coincidence that the downturn in profits growth in 1995 was followed promptly by a slow down in business investment. This capital-spending slump, in turn, essentially has aggravated the profits squeeze.

Except for the booming stock market, the evidence of a weakening economy is overwhelming. Lower profits, lower investment, lower growth in consumer income and spending – these are the decisive trends that lead us to conclude the Fed's next step will be to cut interest rates, probably early next year, to fight undesirable economic weakness.

But deteriorating profits are not the only threat to the bull market. Another is the pronounced deterioration in the underlying supply-demand conditions. In the last two years, the market has had two massive buyers: corporations and mutual funds. In 1995, net corporate stock purchases in the wake of mergers, acquisitions and buy backs hit $74 billion, a new record. These purchases soared even higher in the first quarter of 1996, to $106 billion at an annualized rate, but in the second quarter they subsided quite sharply, to a mere $17 billion.

In previous letters, we repeatedly have wondered about the strange circumstance that heavy buying of stock mutual funds by private households has been matched by heavy selling of direct stock holdings. Belatedly, this riddle has been solved by the Investment Company Institute, the trade association for the U.S. mutual funds industry. It reports that as much as half, perhaps more, of the new money pouring into mutual funds hasn't come from bank deposits or other short-term investments but rather from the liquidation of other stock holdings.

Retirement money, in particular, has been shifting from corporate pension funds to mutual funds. To avoid long-term pension obligations, companies increasingly have been switching to so-called "defined contribution" plans, such as 401(k) accounts, that let employees worry about investing to finance their old-age pensions. Many of these employee-investors have been placing their 401(k) retirement contributions in stock mutual funds. In many cases, these contributions are partially matched by their employers.

The net result is that money that once would have been steered into pension funds, which hold stock directly, now goes into mutual funds, which hold stock indirectly for fund shareholders. At the same time, pension funds have turned into sizable net sellers of U.S. equities. In the first half of 1996, these sales ran at an annual rate of more than $100 billion. During that same period, holdings of retirement money in mutual funds rose at an annual rate of $60 billion.

Essentially, this puts the mutual-fund "mania" in a new light. Its net impact on the stock market is far less bullish than generally has been supposed. Besides, it simply shifts stock holdings from strong hands to weak ones. This makes clear that, after all, it's the heavy corporate buying of stocks that has driven the bull market forward.

DERIVATIVES RULE

We have been observing these negative underlying trends in the stock market for some time now. In our view, they suffice to trigger a full-blown bear market, not just a temporary consolidation – even if the Fed does slash interest rates. In fact these negatives led, or rather, misled us to judge the summer downturn of the stock market as the beginning of the end of the bull market. Accordingly, the latest burst of buying, which has elevated share prices to new record highs in recent weeks, took us by surprise.

Given the sharply deteriorating fundamentals, we have been pondering sources and reasons for this new outbreak to the upside. Could it have been a final speculative blow off? After a close and critical look at the currents in the stock market we have concluded that it definitely was not investment money that powered the latest rally. More than anything else, it was massive speculation with derivatives. This type of trading now rules markets. The point to see is that this ever-increasing use of derivatives, both for hedging and for speculative purposes, drastically has changed the internal dynamics of the markets.

These new dynamics, which we regard as significant and underappreciated, arise from the tremendous proliferation of hedge funds, mutual funds, brokerage firms and institutional investors utilizing ever-more aggressive financial engineering strategies. They are the ones who make the huge turnover, and they also are the ones who react and overreact to any bit of news.

Importantly, the rapid growth of this group of players has been associated with an even faster growth in the use of derivatives, both for hedging and speculative purposes. Particularly noteworthy is the growing popularity of so-called "market-neutral" strategies where hedge funds – and an increasing number of mutual funds – own or buy stocks while simultaneously shorting other shares believed to be fundamentally overvalued.

It is the prevalence of these more sophisticated strategies, not rampant bearishness, that has led to the dramatic and much-noted growth in outstanding short interest. By fostering aggressiveness, this practice essentially has fostered volatility and an ever-increasing dislocation from the fundamentals. We remember all too clearly the role that market-neutral strategies played in the boom and bust in the credit markets back in 1993-94.

One particularly common strategy adopted by portfolio managers is to hedge market risk by purchasing "out-of-the-money" put options while at the same time paying for this protection by writing out-of-the-money call options. This strategy, in particular, has exacerbated market volatility. In a declining market, as the puts move deeper "into the money," the writer and seller of those options must sell stocks to hedge his exposure. Conversely, in a rising market, it is the call options that move into the money, necessitating the purchase of stock to hedge the calls written. In this way, any significant move in the markets tends to provide heavy leverage in either direction. Thus, bearish bets regularly have been followed by even higher prices, as a result of short covering.

Clearly, the May/June runup in stocks was dominated by a savage short squeeze in the speculative Nasdaq stocks. Fundamentally dictated short positions, many established as hedges against long positions, where built up to unbelievable levels. As stocks rose and a squeeze developed, it attracted increasing amounts of speculative buying until a full-fledged buying panic erupted.

This situation was particularly troublesome to the many players running a hedged long-and-short strategy. As the stocks they had sold short shot up, they endured huge losses, triggering aggressive covering programs to mitigate those losses. The result: an irrational "melt-up" in many speculative stocks and in the Nasdaq market overall.

In a similar way, the seeds for the stock market's recent run to new index highs were planted during the market's sharp weakness in July. According to market rumors, hedge funds suffered big losses on the call options they had written, especially on the Nasdaq 100 Index, the Philadelphia Semiconductor Index and many individual technology stocks. To hedge against an expected decline of the market, they had written put options *en masse.* These had to be covered by buying stocks when the market rose again in August and September. Thus, the Nasdaq 100 rallied over 33% from its July lows, adding almost $180 billion of market capitalization.

Another major derivatives play put on during the July weakness was the "collar" trade, in which fund managers wrote call options and purchased put options as a hedge. As in May and June, heightened volatility dramatically increased option premiums, prompting the selling of calls to cover the cost of the expensive put options.

In the wake of these developments, a whole industry has evolved to trade and speculate in this new product -- high volatility. Ironically, it is precisely the product of these strategies that is supposed to eliminate any risk. In the age of momentum, buying simply begets buying, and high volatility becomes self-feeding.

We view this popular hedge fund and, increasingly, mutual fund strategy of owning equities while simultaneously shorting stocks believed to be fundamentally overvalued as not only responsible for much of the high short interest, but also as a major destabilizing influence on the markets. In the past, there always were short squeezes, but the short seller community was small and usually found its targets in smaller cap, obscure companies. Today, with the immense size of the funds that are involved in this "hedging" strategy, the targets have shifted to larger, more liquid stocks and market indexes. The financial power behind these trades now is virtually unlimited.

So far, these dynamics overwhelmingly have worked on the upside, providing for self-reinforcing leveraged buying sprees. But some day, these same influences and mechanisms will work with similar force on the down side.

THE FUNDAMENTALS CAN ONLY GET WORSE

We have gone into this detailed analysis of the forces underlying the recent big speculative waves in the U.S. stock market because the continuous bull run of that market has been in flagrant contrast to the negative profits trend, as measured by profits per share. NIPA profits, too, were absolutely flat during 1995. While they have

recovered somewhat in the first half of 1996 on the back of the strongly rebounding economy, this hardly heralds a renewed uptrend.

Our pessimism about profits has its starting point in the recognition that the extraordinary profits boom of 1991-94 had temporary causes, such as falling interest rates, lower taxes and unusually low depreciation growth. These forces now have played themselves out. Given last year's collapse in profits growth, short-term improvements certainly are possible. But the future trend will depend decisively on the U.S. economy's growth performance – in other words, on "top line" revenue – since productivity gains remain lackluster.

So far in 1996, U.S. economic growth continually has surprised on the up side. But before we extrapolate a foregone, bullish conclusion for next year, it should be remembered that last year the economy just as continuously surprised on the weak side. Its real growth rate from fourth-quarter 1994 to fourth-quarter 1995 was an abysmal 1.25%. Even though profits stagnated, stock prices surged roughly 33%.

For us, the growing discrepancy between ever-higher valuations and deteriorating fundamentals – of which stagnating profits are the most important – has gone to such extremes that the risks have become overwhelming. But a catalyst will be required to trigger a full-blown bear market. After what we have analyzed and described, we discern two likely candidates: an impending sharp drop in U.S. economy activity, and worsening profits.

This stands in gross contrast to the Wall Street consensus view, which expects sustained, if not strengthening growth, with a possible or probable rate hike by the Fed. Only a small minority seems to worry about a deteriorating outlook with slower growth and lower profits. The remaining weeks to Christmas will be crucial in giving us the answer.

Experience says that unexpected events impact the markets most strongly. In this light, a sharply weakening economy, taking the markets, completely by surprise, ought to have rather dramatic effects on bonds, stocks and the dollar. Initially, stocks and bonds well might rise, since Wall Street loves nothing better than a sluggish economy and its supposed promise of lower inflation and lower interest rates, which are seen as wonder drugs for bullishness all around. Some speculators, apparently, would even bet that such a scenario would imply a stronger dollar, on the assumption that rising bond prices would attract foreign capital.

DESIRED VERSUS UNDESIRED ECONOMIC WEAKNESS

When using the term "economic weakness," we must make a most important distinction, namely, between desired and undesired weakness. Wall Street is yearning for just the right amount of weakness: growth at or near capacity limits. This is thought to be robust enough to allow for strong profit growth, but not strong enough to risk inflation and higher interest rates. What we have in mind is real weakness, far more than Wall Street likes. If the consumer's Christmas spending spree fails to materialize, the U.S. economy is in for a recession. No alternative source of demand growth is in sight.

In the first place, such undesired weakness would devastate business profits. Their recent stagnation would give way to a slump. It would pull the rug out from under the existing, extreme stock valuations. Above all, it would destroy the whole bullish psychology in the markets that has developed around the belief that the Fed has full control over the economy. It would show that the Emperor has no clothes.

No less important, and perhaps more, are the probable effects of a slumping U.S. economy on the dollar. A sharply weaker dollar is the single greatest threat to global equity markets and to the economic recoveries in Europe and Japan. The dollar's rally in the past few months has played a key role in generating optimism in this regard. But there may be too much complacency about the Clinton administration's recent preference for a strong dollar.

In the recent past, the strong dollar policy clearly coincided with America's own best interests. With capacity constraints emerging and the markets jittery about inflation, the strong dollar policy served as a quick and easy way of dampening economic activity and inflation.

But there has been a long-term cost to this policy: a drastic, progressive deterioration of the trade deficit, which has risen to an all-time high. This has cut significantly into U.S. economic growth. The burgeoning trade deficit was desirable, as long as the economy seemed poised to overheat. A weaker economy, however, will make the high deficit definitely undesirable.

Adding to the pressure for a reversal of the Clinton administration's lukewarm support for the dollar is the worsening economic situation in Japan. With recent indicators pointing to a renewed slump in both personal consumption and business investment, Japanese authorities find themselves running out of policy options for stimulating the economy.

With short-term interest rates already at a meager 0.5%, the Bank of Japan has nearly reached the limits of its ultra-easy monetary policy. A series of massive public-works spending packages have lifted Japan's fiscal deficit to 8% of GDP, putting it on par with Italy in the world's league of deeply indebted governments. The scheduled remedy for that embarrassing situation – a national sales tax increase scheduled to take effect early next year – will only further depress already sluggish domestic demand.

Japanese policymakers would appear to have no alternative but to push for further yen devaluation, in hopes of reviving Japan's export sector, the traditional motor of past economic recoveries. Certainly, the Bank of Japan is capable of engineering such a decline, if it is willing to accelerate its already massive purchases of dollars and U.S. Treasuries. But at a time of U.S. economic weakness, such a move could hardly be looked upon favorably by the Clinton White House.

The net result, we think, could be a truly bizarre confrontation, with the American government angrily trying to undermine its own currency, and the Japanese government just as frantically trying to defend it. We can only wonder what the markets will make of such a role reversal.

CONCLUSIONS

Our decisive, basic assumption for 1997 is that there will be a distinct weakening of U.S. economic growth. Principally, that's positive for bonds but highly negative for stocks and the dollar, though the initial effects may be bullish all around.

Our bullishness for bonds is limited by the realization that global bond markets are overextended by heavy leverage through the international carry trade. But it appears loose money will stay with us for as far as the eye can see.

In Europe and Japan, the ongoing economic recoveries will remain sluggish enough to preclude any monetary tightening. A weak dollar is the single greatest threat to these recoveries, as well as to global equity markets.

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